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# EXECUTIVE SECRETARIAT

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SUSPENSE

Remarks:

*/Executive Secretary*

*2/18/83*

Date

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OFFICE OF THE SECRETARY OF THE TREASURY  
WASHINGTON, D.C. 20220  
February 18, 1983

83-0596/1

UNCLASSIFIED  
(With Confidential Attachments)

MEMORANDUM FOR THE VICE PRESIDENT  
THE SECRETARY OF STATE  
THE SECRETARY OF DEFENSE  
THE SECRETARY OF AGRICULTURE  
THE SECRETARY OF COMMERCE  
THE DIRECTOR, OFFICE OF MANAGEMENT  
AND BUDGET  
CHAIRMAN, COUNCIL OF ECONOMIC ADVISORS  
ASSISTANT TO THE PRESIDENT FOR  
NATIONAL SECURITY AFFAIRS  
ASSISTANT TO THE PRESIDENT FOR  
POLICY DEVELOPMENT  
UNITED STATES TRADE REPRESENTATIVE  
DIRECTOR OF CENTRAL INTELLIGENCE

SUBJECT Senior Interdepartmental Group on International  
Economic Policy (SIG-IEP)

Attached please find background materials on the Export Administration Act and Debt Strategy for the meeting of the SIG-IEP to be held on Tuesday, February 22, at 3:00 p.m., in the Roosevelt Room. Agenda item number 2, Agricultural Issues, will be the subject of an oral report.

Attendance will be principal, plus one.

*David E. Pickford*  
David E. Pickford  
Executive Secretary

Attachments

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## RENEWAL OF EXPORT ADMINISTRATION ACT

1983

The Export Administration Act (EAA) governs a program which monitors and prohibits exports for national security, foreign policy, and short supply reasons. The current Act was passed in 1979 and expires in September, 1983 unless reauthorized by Congress. Congressional hearings have already begun on the renewal of the EAA and on alternative legislation. The Administration Bill -- to be timely -- must be presented to Congress in March.

The major sections of the Act include: a) National Security Controls; b) Foreign Policy Controls; c) Short Supply Controls; d) Antiboycott Provisions; and e) Enforcement.

The Antiboycott section is the only section which does not proscribe exports to specified destinations. This section requires U.S. persons to refuse to take actions, furnish information, or enter into agreements which further the restrictive trade practices or boycotts imposed by any foreign country against a country friendly to the United States or against any U.S. person.

The other sections define criteria for prohibiting or regulating exports. Pursuant to the National Security Controls section, a list is maintained of items and technical data that require individual licenses before being exported to certain destinations. This Commodity Control List (CCL) also designates items on an international list for which other countries voluntarily require inter-governmental approval prior to export to proscribed countries.

The Foreign Policy section describes criteria for prohibiting exports in order to further significant foreign policy goals of the United States. The recent Soviet gas pipeline sanctions as well as human rights and anti-terrorism controls are examples of foreign policy export controls.

The Short Supply section describes particular commodities controlled in the event of national shortages, and the criteria for controlling exports of such goods. Alaskan crude oil and refined petroleum products, among others, are controlled under this section.

### Current Renewal

This year's renewal takes place in a particularly complex international environment, characterized partly by the following factors:

1. differences among the NATO allies on export controls;
2. recession in the international economy;

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3. business concerns about competitiveness and reliability;
4. concerns over human rights violations occurring in countries which are potential export markets;
5. concerns about the Soviet military buildup;
6. aggressive political and military behavior by the Soviet Union and its allies.

These factors have thrown the spotlight on the national and multilateral export control programs, making this year's reauthorization of the EAA a controversial and delicate matter.

#### The Interagency Review Process

Since last fall, an interagency review of the EAA has been underway. Six public hearings were jointly held around the country by the President's Export Council and the Departments of Commerce, State and Defense to solicit private sector input into the review process.

The Advisory Committee on Export Policy, (ACEP) at the Assistant Secretary's level developed a set of proposals for an Administration bill to amend the EAA. These recommendations focus on: 1) the policy to seek to prevent excessive dependence on energy and other critical resources of potential adversaries; 2) the imperative nature of multilateral control negotiations with our allies; and 3) the compliance of foreign sources with national security and foreign policy controls. The ACEP recommended no changes in the Foreign Policy Controls section of the Act.

The ACEP and individual agency proposals were submitted to an Under Secretary group for review. The outgrowth of that review is a draft options paper, focusing on the key issues proposed by the ACEP, by individual agencies and by the business community. This options paper will be presented shortly to the SIG-IEP for its consideration and decision.

#### Congressional Status

A number of export control and enforcement bills have already been introduced. The bills must be out of committee by May 15.

The Garn Bill: As Chairman of the Senate Banking Committee, Senator Jake Garn (R-Ut.) has principal jurisdiction over the EAA in the Senate. Senator Garn has reintroduced a bill that would tighten up on export licensing for national security purposes and would reorganize the interagency structure for administering controls. An independent Office of Strategic Trade headed by a Director with Cabinet status, who would also be a member of the National Security Council, would be created.

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The Heinz Bill: Senator John Heinz (R-Pa), chairman of the Banking Committee Subcommittee with jurisdiction over the EAA, has introduced a bill that focuses on: 1) loosening controls on goods and technology available from foreign sources; 2) providing sanctity of existing contracts against the imposition of foreign policy controls; 3) moving the enforcement function from Commerce to the Customs Service; 4) strengthening the tests government must meet for imposing foreign policy controls; 5) imposing import controls on countries on which export controls are applied; and 6) requiring consultation with Industry Sector Advisory Committees (ISAC's) before imposing foreign policy controls.

Both Senators Heinz and Garn have stated during hearings that their bills should be combined as "drafts" and have expressed a willingness to negotiate their provisions.

The Nunn Bill: Senator Sam Nunn (D-Ga) introduced a bill which would shift the export control enforcement functions from Commerce to Customs.

The Byron Bill: Congresswoman Beverly Byron (D-MD) has introduced a bill which would create a National Security Control Agency within the Defense Department, and give DOD an express override on all security-sensitive exports. The Byron bill does not contain foreign policy, short supply, or antiboycott sections. Therefore, separate legislation would be required to carry on these functions.

#### The Business Community

The business community has a great interest in the renewal of the EAA and is well organized in its efforts. In addition to many letters sent to Commerce and other agencies, more than fifty statements on the EAA were delivered by interested industry representatives during the six public hearings. The business community wants limitations placed on the imposition and extraterritorial reach of foreign policy controls. Business wants better consultation and economic impact studies done before imposition of controls as well as contract sanctity against the later imposition of controls. In the national security area, Business wants more emphasis placed on multilateral instead of unilateral controls; less restrictions on "West-West" trade including elimination of licensing requirements for products and technology to COCOM countries, Australia and New Zealand; and more emphasis on control of sensitive technology and less control on the products of that technology.

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February 18, 1983

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(ENTIRE TEXT)

International Debt Situation and its Impact on  
the World Economic/Financial System

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(ENTIRE TEXT)

Classified by Thomas B.C. Leddy  
Office Treasury/IM  
Declassify on December 31, 1987

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I. The Current Situation and How We Got Here.

The present troubled state of the world economy has its roots in the sixties and was greatly exacerbated by the twin oil shocks of the seventies and consequent policy responses, which attempted to avoid adjustment to new economic realities. During the second half of the sixties, growing inflationary pressures and maintenance of fixed exchange rates led to progressively greater misalignment of exchange rates and a growing misallocation of resources in response to faulty relative price signals in the international economy. At the same time, the role of governments in domestic economies was undergoing substantial growth, accounting for an increasing share of national income.

By early 1973, major exchange rate realignments and the move to generalized floating exchange rates seriously affected the competitive position of major industries in Europe and Japan. Instead of supporting adjustment to the new pattern of competitive positions, governments, especially in Europe, tried to preserve the viability of the major capital stock buildup, the concentration of the labor force in these now less competitive industries, and the high real incomes (and continued rising living standards) to which populations had become accustomed. The major changes in relative exchange rates of early 1973 were followed within less than a year by the oil embargo and a quadrupling of world oil prices. All of these developments were superimposed on a synchronized boom in world output, rising commodity prices and decline in the value of financial assets.

The economic situation called for monetary and fiscal restraint to reduce inflationary pressure, and for real adjustment and resource reallocation to reflect new competitive conditions and the reduced real consumption possibilities implied by the large transfer of income and wealth to OPEC. However, governments instead typically tried to maintain real incomes at levels prevailing prior to the price increases and preserve employment in uncompetitive industries by transfers. Reluctance to fund these transfers and subsidies by increased taxation led to debt-financed increases in government outlays, with monetization of the resulting deficits producing faster monetary growth in turn. The results were higher inflation, slower real growth, and rising government sector deficits relative to GNP.

By the end of the seventies, the world economy faced a second oil price shock and a further worsening of underlying fundamental economic conditions: inflation rates continued the upward trend started in the late sixties, averaging 8.4 percent for the decade, compared to only 3 percent for the sixties; government command of national income in Europe rose to 46 percent, some 50 percent larger than in the early sixties.

The sharp increases in oil prices were also reflected in a dramatic shift in the global distribution of current account

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balances. During the sixties, the industrial nations experienced modest current account surpluses, compatible with the view that the mature industrial countries should normally be net exporters of capital to the LDCs, in order to facilitate the importation of capital goods needed for development purposes; and the LDCs experienced modest current account deficits during the period.

After 1973, this current account relationship was dramatically altered. Due to sharp oil revenue gains, OPEC moved into current account surplus and became the net capital exporter to the oil importing world -- both industrial and LDC nations. From 1974 to 1980, the industrial nations faced current account deficits which averaged \$14 billion per year, and the non-oil LDCs annual deficits of \$40 billion. These large shifts into current account deficit placed huge demands for financing on international financial markets.

Most of the financing was generated in private markets, largely by commercial banks, and reflected in large part the growth of OPEC financial assets. Commercial banks became the risk-taking intermediaries between OPEC and borrowing countries. The growth of lending was considerably larger than many observers had thought possible; but the corollary has been the rapid growth of international debt.

In addition, the liquidity provided by the growth of lending has tended to postpone adjustment of domestic economies and helped maintain consumption at inflated levels. Continued borrowing and postponement of adjustment was encouraged by the belief on the part of debtors that inflation would erode their debt burden and by the continued availability of funds to banks at negative real interest rates (with OPEC and other depositors in essence absorbing the erosion of real asset values as the counterpart of LDCs' gain).

The increase in international lending was heavily concentrated on the non-oil LDCs. Following the second oil price shock, there was a large increase in private bank lending to the non-OPEC LDCs. Net new borrowing by these countries from banks in the major industrialized countries reached a cyclical low of under \$15 billion in 1977, rose to around \$39 billion in 1979 (of which \$25 billion went to Latin America) and to \$48 billion in 1981 (of which \$35 billion went to Latin America). The "real" magnitudes are reduced after allowance for inflation; but, by June 1982, the stock of debt owed to private Western banks by non-oil developing countries totaled around \$268 billion, of which \$178 billion was owed by Latin America. The bulk of the outstanding claims of BIS-area banks on Latin America is on

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billion).\* U.S. banks account for about 40 percent of this amount.

Ample bank liquidity encouraged growing lending flows, and competitive pressures tended to lower spreads, raising the legitimate question whether the banks were being adequately compensated for risk. Occasional repayment difficulties for small countries usually led only to rescheduling at higher interest rates and extra fees, thus failing to disturb banker complacency.

In the summer of 1981, questions began to be raised, even in the banking community, about the ability of a number of major borrowers to continue to service their debts. But the authorities in some of these countries, such as Mexico, were unwilling for domestic political reasons to adopt the serious economic adjustment programs required to reduce their balance of payments deficits and external financing requirements.

#### Changed Economic Environment

In recent months, financial markets have begun to recognize that the inflationary environment of the seventies is being fundamentally changed. Markets are beginning to believe the world economy is in a period of disinflation and that this will continue for some time. Inflation expectations are undergoing dramatic change. As a result, lenders are re-evaluating loan portfolios that were established under quite different expectations about future inflation. Levels of debt previously expected to decline in real terms -- and therefore to remain manageable relative to growing nominal export receipts under conditions of high inflation -- are now seen to be high in real terms and large in the face of weak LDC export prices and the slow world growth accompanying the transition to a non-inflationary environment. Interest rates -- though recently down in nominal terms -- are seen as still high and more burdensome in real terms because of lower expected inflation. On the other hand, the likelihood that real interest rates will decline is a positive factor in the outlook.

These re-evaluations are the inevitable result of a collision between ongoing inflationary behavior and monetary policy that no longer provides sufficient money to finance continued high inflation. In general, national monetary authorities are demonstrating that anti-inflationary policies will not be reversed at the first signs of slow growth or higher unemployment. The world economy is in the midst of an unavoidable adjustment that will

\* While these data do not capture all bank lending, the numbers if anything probably overstate actual private bank exposure since they include those claims that are guaranteed--principally by export credit agencies. (N.B. 1981 figures incorporate valuation effect of exchange rate changes.)

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continue until inflationary expectations abate and the public's behavior ceases to be based on the presumption that inflation will persist into the future as it has in the past.

## II. Potential Options.

Given the serious financing and adjustment problems facing a growing number of countries, some have called for a massive wealth transfer from the industrial countries to help finance continued external deficits. Such transfers would take the form of large-scale creation of SDRs and an allocation specifically targeted for the LDCs. While appearing in some ways to be a tempting solution, the ultimate effect of such large SDR allocations would be to postpone much-needed adjustment by the LDC recipients and to encourage maintenance of already excessively large current account deficits. The temporary relief from financing constraints would perpetuate inflationary policies and the misallocation of resources in the developing countries, and would not contribute to a lasting resolution of financing difficulties.

Others have suggested that the solution to LDC financing problems could take the form of action by the industrial countries to shift domestic policies strongly towards expansion -- larger budget deficits and faster monetary growth -- to provide rising demand for LDC exports. This "locomotive" approach -- where industrial country growth pulls LDCs out of their financing difficulties -- would be doomed to failure for two basic reasons. First, strongly expansionary policies would rekindle inflationary pressures in the industrial countries, which would both spill over the LDCs (via rising import prices) and eventually abort the recovery itself. Second, the temporary and artificial boost to LDC exports would remove adjustment pressures and postpone needed LDC domestic policy reforms.

It has also been suggested that major borrowing countries might engage in a unilateral debt moratorium or repudiation. This possibility cannot be denied, but its probability is quite small. It would imply long-term loss of access to international credit and capital markets and a breakdown in the international trading patterns of the country concerned. Its goods, ships, planes and other overseas assets would be attached. Even its postal communications would probably come to a halt.

In short, it would not be in the self-interest of the sovereign debtors themselves. What is likely to happen instead -- what is already happening -- is a series of debt reschedulings in which the borrowers take domestic adjustment measures, frequently in association with IMF programs, and work out with creditors, both public and private, a revised and lengthened maturity schedule.

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### III. Prescriptions.

The current strains on the international economic and financial system should not develop into a major, disruptive crisis provided that:

- The debtor countries take the necessary domestic adjustment measures.
- Treasuries and central banks are prepared to act immediately to provide short-term finance to countries with severe liquidity difficulties, to provide time for orderly adjustment programs and longer-term financing to be arranged.
- The resources of the IMF are increased to give adequate medium-term official balance of payments support to finance LDC adjustment measures.
- Private lenders are prepared to maintain and increase exposure in countries following appropriate adjustment policies.
- Central banks and regulatory agencies are seen to be -- and in fact are -- able to provide adequate credit and lender of last resort of facilities as needed, both domestically and internationally.

This section outlines the main elements of a comprehensive strategy to achieve an orderly resolution of the debt situation.

#### A. Increase in IMF Resources

The crux of any effort to remedy the debt problems of less developed countries in a lasting way must be domestic adjustment efforts by the countries themselves. These, however, are unlikely to be possible and politically palatable without continued flows of external financing. The international institution best able to provide official balance of payments support within the context of domestic economic adjustment is the IMF (supplementing continued lending from the commercial banking system).

The current LDC debt situation mandates the need for assurance of sufficient IMF facilities. The Administration supports an increase in IMF quotas and establishment of borrowing arrangements in favor of the IMF sufficiently large to assure adequate and prompt funding of the IMF. It has been agreed that the next Interim Committee meeting to decide on the increase in IMF resources be moved forward, to February 10-11, 1983; and that the target for implementation be advanced to end-1983.

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The IMF historically has required borrowing countries to agree to a domestic adjustment program as part of the conditionality for its lending. The U.S. should urge that the Fund take a strong stance against trade restrictive measures that might otherwise form part of an adjustment package. Conditionality requirements, given world macro-economic conditions, will need to recognize that debtor countries' ability to redress their external financial positions through increased exports will be limited until there is a revival of economic expansion in the industrialized nations.

B. Availability of Short-term "Bridging" Support by Central Banks and Treasuries

As in major recent cases, there is likely to be a continuing need for immediate ad hoc liquidity support which can be made available to countries while they formulate adjustment programs, negotiate with the IMF, seek to arrange orderly financing programs with the banks, and begin the process of program implementation.

The central banks, often working under the aegis of the Bank for International Settlements and at times supplemented by U.S. Treasury resources (Exchange Stabilization Fund), can provide short-term financial assistance, under appropriate conditions and with adequate assurance of repayment, until the borrower can work out an IMF adjustment program. There is a prearranged swap network among the major industrial countries, and, in the U.S. case, a swap agreement with Mexico. In the absence of an international central bank, the central banks in effect provide the immediate blood transfusion required to keep the patient breathing until it comes under the IMF's "intensive care" requirements.

There is scope for a review of the adequacy of the central bank arrangements to deal with as yet unidentified problems. By their nature, these result in ad hoc solutions, but the Federal Reserve Board and Treasury will need to be prepared to take the initiative with their counterparts in Europe and Asia to assure the adequacy of the potential response.

C. Maintenance of Commercial Bank Lending

In an aggregate sense, the role of the commercial banks overshadows that of all other lenders combined. For example, at the end of 1981, total non-OPEC LDC debt totaled about \$480 billion, of which \$254 billion (53 percent) was owed to private banks. During the first half of 1982, the proportion of debt to the commercial banking system increased further.

In the second half of 1982, U.S. regional and some European and Japanese banks have sought to limit or reduce exposure. To the extent they are successful, they place a greater and disproportionate strain on the resources of the larger international

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banks and official lenders. The result is to reduce financing and remove liquidity, placing greater strain on the LDCs, already faced with a severe adjustment burden. This increases the risk of abrupt and potentially politically destabilizing adjustment, rather than a more gradual, albeit still painful, process of adjustment.

Central bank governors from the U.S., the U.K. and Germany, and the Managing Director of the IMF have stressed that the LDC situation cannot be turned around overnight. Lower inflation, reduced interest rates and slower economic growth bring with them a reduction in the need for increased commercial bank financing. However, some net new lending must take place, if only to help finance short-term trade and necessary imports which in turn are required in the export process. A cessation or severe curtailment of commercial bank lending is not in the interest of the lending banks themselves. In some cases, it could push otherwise weak but still viable borrowers into a rescheduling.

All those commercial banking institutions -- large and small -- that have played a part in the international lending that enabled LDC borrowers to run up debt, sometimes non-productive and non-foreign exchange earning, must be made aware and encouraged not to reduce exposure during the adjustment process that is underway. They have a collective responsibility. Specific recommendations will be made in a following section on banking issues.

#### D. Multilateral Development Bank Policies

Although the Multilateral Development Banks do not play a role in meeting emergency financing requirements, the IBRD does provide structural adjustment loans in some instances. These provide fast-disbursing financial support, and can be used in conjunction with economic adjustment programs supported by the IMF.

The Administration should continue to try to get adequate funds for the Multilateral Development Banks, although the IDA replenishment is not directly relevant to the debt problem. In these institutions, the U.S. should (a) continue to encourage development of private sector oriented, investment-inducing policies; (b) continue to encourage co-financing ventures with private lenders as a means of increasing resources and focusing attention on commercially viable projects; and (c) be prepared to support structural adjustment lending in selected cases in connection with IMF programs.

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E. Adequacy of Domestic Credit Expansion and Lender of Last Resort Facilities

The central banks and monetary authorities of the industrialized world have a collective responsibility to provide sufficient credit to help assure a realistic and gradual, rather than cataclysmic, world adjustment process. The international depression years of the 1930's were marked by a steady decline in money and credit.

A repeat is not likely in the circumstances of the 1980s, but assurances that such a development will not be allowed to repeat itself could have some confidence-building effect.

Toward this end, the U.S. should ask Finance Ministers and Central Bank Governors in G-5 and G-10 countries to consider a joint declaration to this effect, which could also encompass a reaffirmation of earlier statements on adequacy of international lender of last resort provisions, and a clearer understanding for international supervisory and prudential responsibilities.

F. Increased Availability of Official Financing

Increased direct assistance from official lenders can make a significant remedial contribution to troubled LDC debtors, as well as serving the commercial and financial interests of the lending country.

Increased U.S. assistance to major LDC borrowers under the Economic Support Fund and Military Assistance appears limited; over half is already programmed by Congress for specific countries (e.g., Israel, Egypt, Turkey, El Salvador, Pakistan).

U.S. facilities that are in place, and which appear to offer possibilities for expanded use, are the agricultural export loans guaranteed by the Commodity Credit Corporation and Export-Import Bank programs, which also rely to some extent on use of guarantees.

Given the problems of LDCs, including the shift to a disinflationary world macroeconomic environment and falling commodity prices, it is in the self-interest of industrialized countries to assist their adjustment. The Administration should be prepared to consider a significant increase in use of CCC and the guarantee programs of the Export-Import Bank, to enable U.S. exporters to help provide further adjustment assistance at the conventional terms normally charged by those institutions.

It must be recognized, however, that guarantees are not "free"; these programs will entail a budgetary cost if the guarantees are invoked and do in any event have an impact on the

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credit market. Moreover, even a significant increase in the programs would cover only a small proportion of the prospective decline in private bank lending.

As noted above, the Treasury's Exchange Stabilization Fund can in limited instances provide very short term financing, primarily as a "bridge" to expected financing from other sources of longer maturity. It is not suitable as a means of providing an overall increase of financing flows to LDCs.

G. Credible Economic Expansion in U.S., Europe, Japan

One of the key factors for a recovery currently missing in the world economy is business and consumer confidence. Investment spending is being postponed as capacity utilization remains low and gloom and doom predictions about the global economy become commonplace. This lack of confidence spreads to consumers who, fearing the possibility of unemployment, postpone consumption in favor of rebuilding savings levels. At the current juncture, most economic actors have adopted a "wait and see" approach -- a decision which collectively can lead to an immobilized world economy.

There are some factors that increase the prospects for a sustained recovery: inflation rates in most major countries have receded importantly; nominal interest rates have fallen sharply; and inventory rundowns are largely complete. But most observers are unable to see the Moses sector which will lead the industrial economies along the road to recovery -- they do not foresee the next growth sector that will reignite investment and consumption decisions.

Solid, observable U.S. recovery is the key to world economic expansion. As the largest economy, the success of our recovery after experiencing the high costs of disinflation is critical to reestablishing confidence. As domestic demand recovers, our imports are likely to expand sharply. Current projections suggest a \$35 billion increase in the merchandise trade deficit in 1983 -- slightly more than 1 percent of U.S. GNP. This swing will directly stimulate other economies. Thus, solid expansion in the domestic economy will be important to Europe and Japan as well as to the non-oil LDCs whose current adjustment problems can be eased by an expansion of exports to the industrialized economies.

The second key to establishing a credible expansion in the industrial economies rests in the hands of European and Japanese policy officials. Over the next year, they will be facing important policy decisions. For some, still facing high inflation rates and inflation expectation, there is little choice. For others, there is likely to be some scope for easing monetary and fiscal restraint in order to encourage moderate and stable growth, compatible with their domestic economic situations.

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There are, however, two important dangers in the situation. First, governments may succumb too quickly to political pressures to stimulate their economies further via excessive monetary and fiscal expansion. A major shift at this stage could tend to place upward pressure on interest rates, discourage the downward shift in real interest rates critical to investment-led growth, and suggest a return to the stop-go policies of the seventies. If such an expansion were attempted via increased government spending, it would reverse gains being made in reducing the involvement of governments in domestic economies.

Secondly, rising protectionist pressures in the U.S. and elsewhere pose a real threat to global recovery. If the U.S. in particular attempts to postpone or arrest its growing trade deficits, the growth effects on our trading partners will be diminished and the confidence factor will disappear.

#### H. Protectionism Must Be Avoided

With high and rising unemployment and large external financing requirements throughout the world, the temptation to undertake protectionist trade policy is increasing. Signs already exist that governments are turning to protectionist trade measures in an attempt to preserve jobs in non-competitive industries and to reduce imports and/or increase exports. There is a real danger of spreading protectionist measures over the next year. Far too quickly, governments could react to trade measures by imposing their own restrictions in a futile attempt to offset the efforts of other countries' trade policies.

As the world's largest trader, the U.S. carries a major responsibility to lead the world away from a possible trade war. The clearest and strongest signal for other countries would be for the U.S. to renounce protectionist pressures at home to preserve its essentially free trade policies.

#### IV. Related Banking Issues.

##### A. Maintaining Commercial Bank Exposure

It is a tenet of U.S. financial policy that banks must be responsible for their own commercial judgments. The Administration should not attempt to dictate their lending decisions. At a time of increased risk, bankruptcies and problems in domestic markets, reschedulings by sovereign borrowers, tiering of borrower rates and cutting credit lines against less than prime names in interbank markets, it is understandable that financial institutions would be examining their exposure levels and basic commitment to continued international lending, especially to problem borrowers.

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Unfortunately, what may seem like wisdom for an individual bank may be folly and irresponsible if followed by the banking system as a whole. Borrowers such as Yugoslavia and Brazil have seen a massive runoff in funds available. Otherwise viable borrowers may well be pushed into reschedulings. The increase in private banking funds needed to assist in orderly adjustment simply may not be available.

The Administration at the highest appropriate levels should point out the dangers and the need for continued, though diminished, private financing during the transition while adjustment takes place. Troops who flee the field weaken the strength of those who remain and may decrease their own chances of survival as well; they usually are not welcomed back by the regiment. Banks whose lending policies helped to increase the debt of LDCs presumably have some moral commitment to work with them in solving their problems. In addition, it is in the banks' own interest.

Care must be taken at the same time that increased U.S. bank exposure does not cover a runoff of funds by other lending countries -- and not only the largest, as Japan, but also smaller G-10 countries as the Netherlands or Switzerland. The G-10 Finance Ministers and Central Bank Governors should work cooperatively to assure this.

B. Better Information on Borrowers Is Required

We don't know who owes how much to whom. The initiative by private bankers to establish an international institute to improve the availability and quality of financial and economic information on major sovereign borrowers should be encouraged.

In addition, the Federal Reserve Board and Treasury should propose a major official effort, initially in the G-10/BIS context, to improve the availability of consolidated data on bank lending and country exposure.

C. Supervisory and Regulatory Considerations

The preceding sections have stressed the collective capability and responsibility to manage the LDC debt problem and to prevent a crisis of systemic proportions. A major element in the responsibility is the role of the central banks. They obviously are functioning in a framework of heightened uncertainty, yet they must provide confidence and demonstrate that provision of liquidity and lender of last resort functions are adequate to support the international banking framework.

This will not be easy, because they face a paradox. As noted, they are encouraging their banks not to reduce exposure, while at the same time urging prudence in loan loss provisions and improved capital adequacy.

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Chairman Volcker has indicated that new credits, under appropriate circumstances to facilitate the adjustment process in borrowing countries, "should not be subject to supervisory criticism," but the SEC staff have required that "where conditions in a country give rise to problems which may have a material impact on the timely payment of interest on principal on that country's private or public sector debt" (when the aggregate outstanding to that country exceeds one percent of consolidated outstandings) "the country should be identified" in periodic reporting.

There seems to be a potential contradiction: the bank should not be subject to supervisory criticism, but how many banks will step forward with new lending if it puts them above the one percent outstandings and requires special mention in annual or quarterly reports. At a minimum, U.S. "independent" regulators must coordinate to develop a more coherent approach.

The Comptroller and the Federal Reserve Board have proposed consideration of more uniform allowances and provision for possible losses on problem sovereign loans. In itself, the proposal may be overdue, its objectives are praiseworthy. Banks respond, however, that (a) if they are immediately subject to high mandatory provisions, this will reduce profits and funds otherwise available for lending and (b) if not followed on a comparable basis in other countries, it will be a competitive restraint.

At a minimum there appears a need for closer oversight and coordination by the Treasury and Federal Reserve Board to assure that the various USG agencies involved in the regulatory and supervisory area maintain prudential standards and do not work at cross purposes with each other or with broad U.S. international financial policy. In addition, there is a need for increased cooperation by an enlarged number of regulatory authorities in G-10 countries and non-G-10 financial centers to develop an improved assessment of potential strains and dangers facing the international banking system.

#### V. Future Work

General inter-agency consensus on the main elements of strategy outlined in this paper is subject to qualifications on three points: (1) the impact on the strategy if the expected upturn in world economic activity does not develop with sufficient vigor to assist LDC recovery; (2) the real and potential strains on the world trading system that are a concomitant to adjustment -- involving adherence to GATT principles, the danger of a retreat to discriminatory and protectionist measures, and the impact of financial adjustment on levels of trade; and (3) what might be considered in the event there are serious problems with this strategy.

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Further analysis will be carried out in each of these areas, the results of which will be forwarded to the SIG either for information or policy consideration.

A. Forecasts of Economic Growth

The U.S. strategy is premised on a gradual resumption of world economic growth, led by recovery in the U.S., Europe and Japan. Growing economies will increase demand for imports of goods and services from the less developed world, which in turn would ease financing problems and permit some increased demand for the products of industrialized nations. As demand increases and spare capacity is utilized, investment and capital formation should increase. But what happens if economic growth in the U.S. and elsewhere fails to materialize or generates an insufficient rise in demand for exports from debtor countries? What are the potential parameters of a shortfall, and what would be the impact on debt servicing problems of borrowers, future lending from bankers, and the international financial system. The IG-IEP will review the probability of alternative growth paths developing.

B. Trade

All agree that we must watch closely the impact of the LDC debt problem on U.S. trade and insofar as possible have an integrated financial and trade approach to current problems. An improvement in the debt situation, requiring financial restraint and adjustment through the trade account, will entail reductions in imports and increases in exports, at least as compared with the situation in the absence of financing constraints. Adjustment programs agreed with the IMF normally discourage import restrictions and encourage moves toward liberalization; it is important that this general orientation be maintained. To the extent that import restrictions or export promotion measures cannot be avoided, it is important that these be nondiscriminatory and across-the-board, rather than specific or that they call into question or violate GATT rules which underpin the trading system. The deterioration in industrialized nations' trade accounts as a result of LDC adjustment will engender still greater protectionist pressures against LDC exports.

The Trade Policy Staff Committee is developing responses to issues such as: Which trade adjustment measures should the U.S. encourage, tolerate or oppose? How should we react to LDC requests for special preferential treatment? Is there any way of sharing the burden among developed countries? USTR, on behalf of the TPC, will forward to the SIG-IEP the results of the trade policy community's examination of the trade aspects of the debt situation.

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### C. Public Proposals

A number of proposals have been made involving various new mechanisms or institutional arrangements which allegedly might alleviate trade and economic adjustment problems. The following proposals are not a definitive list, nor are they proposals of any agency of the U.S. Government. Many present complex political and technical problems that are frequently discussed as if they offered simple solutions to the problem. The IG-IEP will review and analyze them because, whether prudent or not, they will be proposed as "solutions" and there will be questions about them during hearings on world debt problems.

#### Short Term Proposals

- one year grace on 1983 debt;
- debt equity and exchange participation notes that would base debt servicing on the foreign exchange resources of the borrowing country; lenders would receive a percentage of borrowers' foreign exchange receipts;
- implementation of retroactive terms adjustment, in effect debt forgiveness for the poorest nations;

#### Longer Term Actions

- a commercial debt rediscount facility for commercial loans to developing countries;
- commercial bank safety nets, funded either by the banks themselves or the IMF;
- establish an international debt commission, possibly under IBRD or IMF aegis, to monitor debt conditions, establish criteria for debt rescheduling, and help encourage appropriate policies in borrowing countries;

#### Trade Finance Proposals

- proposals to create a secondary market for trade paper;
- an increased Export-Import Bank role, possibly to provide emergency foreign trade credits to help selected countries during payments crisis;
- establishment of IMF-GATT links, whereby the GATT could review IMF programs for high debt countries;
- pushing trade expansion and countering protectionist pressures, relaxing investment incentives and performance requirements in LDCs;

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--U.S. investment incentives in the form of tax credits could be made conditional on LDC adoption of more liberal trade and investment policy.

Despite the initial attractiveness of some of the proposals, there are substantial negative elements involved. Their practicality, feasibility, international, legal, Congressional and budgetary implications need to be considered. The IG-IEP will review these suggestions on a pro and con basis.

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